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EXCEPTION

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

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JIM IRVIN

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IN THE MATTER OF COMPETITION)
 IN THE PROVISION OF ELECTRIC)
 SERVICES THROUGHOUT THE)
 STATE OF ARIZONA)

DOCKET NO. RE-00000C-94-0165

EXCEPTIONS OF ARIZONA PUBLIC SERVICE COMPANY TO RECOMMENDED ORDER ON RECOVERY OF STRANDED COSTS

Arizona Public Service Company ("APS" or "Company") hereby submits its Exceptions to the Presiding Officer's Recommended Opinion and Order dated May 6, 1998 ("Recommended Order"). The Recommended Order is unjust, unreasonable and unlawful for the reasons set forth below and should be modified accordingly.

I. INTRODUCTION

Since the Arizona Corporation Commission's ("Commission") passage of Decision No. 59943 (December 26, 1996), APS has consistently maintained that the Commission needed to resolve numerous issues relative to the introduction of retail electric competition prior to the scheduled first phase of such competition in 1999. In this regard, the Company is heartened to see progress in this proceeding toward resolving what is clearly one of the most important of these issues, i.e., the method or methods for calculating and recovering stranded costs.

The Recommended Order, while addressing the calculation issue and setting forth a procedure for establishing a stranded cost recovery mechanism, has undermined two of the few heretofore clearly established principles of electric restructuring in Arizona: (1) that a reasonable

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1 opportunity for full stranded cost recovery was, in the Commission's own words "guaranteed;"¹
2 and, (2) that the Commission would abide by the terms of its previous orders relative to regulatory
3 assets. By doing so, it has changed the entire fundamental meaning of A.A.C. R14-2-1607
4 without a word of explanation or a single citation to the record as justification for this radical
5 change in regulatory policy.

6 The Recommended Order's clear articulation on page 8 of its overall goals with regard to
7 stranded cost recovery is clearly a long overdue step forward. However, the actual means
8 suggested for implementation of these goals belie the stated intent thereof and represent two very
9 large steps backward at a juncture where the Commission can ill afford any lost time or effort if it
10 is to meet its objective of beginning retail electric generation competition by the end of this year.

11 **II. THE RECOMMENDED ORDER DOES NOT PROVIDE A** 12 **REASONABLE OPPORTUNITY FOR FULL RECOVERY OF STRANDED COSTS**

13 First among the "primary objectives" cited by the Recommended Order is "a reasonable
14 opportunity to collect 100 percent of [their] unmitigated stranded costs." *Id.* at 8. The
15 Recommended Order thereafter sets forth three (3) "options" for recovery of stranded costs. None
16 provides "Affected Utilities" with any reasonable opportunity for anything close to 100% recovery
17 of stranded costs.²

18 **A. Option No. 1 - "Lost Revenues"**

19 The Recommended Order adopts the method for determining stranded costs recommended
20 by APS, i.e., an annual comparison of embedded cost versus market price.³ APS is, however,

21
22 ¹ Decision No. 59943 at 47.

23 ² For purposes of its Exceptions and in the interests of brevity, APS will not include its oft-repeated
24 arguments as to the Company's legal entitlement under both the United States and Arizona Constitutions to a
25 reasonable opportunity for full stranded cost recovery. These arguments have been presented to the Commission at
length both in this and prior proceedings. By its forbearance in this pleading, however, APS by no means waives or
abandons such legal arguments.

26 ³ The Recommended Order further states that while either the Palo Verde Dow Jones Index or the California
Power Exchange Index would be acceptable, "market price" should include a "blend of spot, short term and long term

1 somewhat confused by the Recommended Order's reference to an annual true-up. *Id.* at 18.

2 Under the method proposed by Mr. Davis, only the 1999 estimates of market price would be
3 subject to true-up in the year 2000. Subsequent years would use the preceding year's actual
4 average market price, and thus no true-up would be either necessary or appropriate.

5 The Recommended Order would phase out stranded cost recovery after 2003. As APS
6 indicated during the hearing (a contention which was not refuted by any witness), APS would in
7 fact incur stranded costs through 2006 and well beyond. The Recommended Order allows no
8 opportunity to recover so much as a dime of these post-2003 stranded costs.

9 Even within the five (5) year "window" allowed by the Recommended Order, APS is given
10 a reasonable opportunity for full stranded cost recovery only during the first two (2) years.
11 Thereafter, its stranded cost recovery is reduced 40% for the third year, 60% for the fourth, and
12 then by 80% in year five (5). This averages just 64% for the period and a much smaller percentage
13 of total stranded costs when the post 2003 years are factored into the total. Although APS does
14 oppose in principle establishing reasonable pre-set goals for mitigation of stranded costs (in lieu of
15 endless quarreling over this or that specific mitigation measure), what is a "reasonable" target may
16 well vary from utility to utility, and therefore each "Affected Utility should be required to make
17 some specific proposal in that regard as part of its stranded cost filing. The Company finds this a
18 better approach than using some arbitrary percentage of disallowance. Moreover, there was
19 certainly no evidence (and none is cited) that would support the apparent assumption that
20 "Affected Utilities" could mitigate over a third of stranded costs during the period 1999-2003 and
21 100% thereafter.⁴

22 _____
23 power." *Id.* at 13 (ft. nt. 7). Although conceptually appealing, the Recommended Order's suggestion ignores the fact
24 that representative short and long term market data may be difficult to discover. Even if such long and intermediate
25 contract information were known, one would still have the problem of separating from the stated contract price, if
26 any, the true price of electric power from other services likely provided in the same agreements (e.g., financing,
insurance, etc.).

⁴ As was thoroughly demonstrated at hearing, it is not the disallowance of stranded cost recovery that
incentivizes mitigation but rather the establishment of a fixed mitigation standard. To that end, any percentage less

1 The Recommended Order attempts to justify this confiscation of the Company's property
2 as a mere "modification" of the APS proposal that is apparently intended to rectify a perceived
3 "major flaw" in such proposal. This so called "major flaw" is that there is little incentive for APS
4 customers to switch to alternative suppliers unless they can "purchase generation at below market
5 price." *Id.* at 11. Aside from the fact that the market price referenced in the APS proposal is an
6 annual weighted average market price, clearly an easier target to beat than a spot price, APS would
7 ask this more fundamental question. If a customer can not, in fact, purchase generation for a
8 lower cost than APS can purchase or generate that same power, why should such a customer
9 expect or deserve "to reap any savings?" *Id.* Far from being a "major flaw," the Company's
10 proposal both promotes and reflects fundamental principles of economic efficiency.

11 B. Option No. 2 - Divestiture

12 Aside from the rather unsubtle attempt to coerce "Affected Utilities" to select Option No.
13 2, the Recommended Order fails miserably in its stated goal of "a reasonable opportunity to collect
14 100 percent of [their] unmitigated stranded costs." *Id.* As noted later in its Exceptions, selecting
15 Option No. 2 would have a devastatingly negative impact on regulatory assets. Ignoring that for
16 the moment, the principle fault of this Option from the standpoint of stranded cost recovery is the
17 failure to allow a return on the unrecovered balance of stranded costs during the ten (10) year
18 recovery period. As any lottery player can tell you, \$100,000 a year for ten years is considerably
19 less than \$1 million today. In fact, at a 9% discount rate (which approximates the Company's
20 "authorized" cost of capital), recovery is just 64% - exactly the same as under Option No. 1,
21 excepting that the calculation does implicitly recognize the impact of post-2003 stranded costs (a
22 plus).

23 The Recommended Order's discussion of Option No. 2 is also devoid of any recognition of
24

25

than 100% would likely be as effective as any other. See APS Reply Brief, Section I.C., The "Incentive to Mitigate"
26 Myth, at 13. However, selecting a goal that is all but unobtainable is simply punitive and may actually prove
counterproductive to mitigation efforts.

1 the tremendous costs that would be incurred in divestiture. First there would be the costs of
2 securing literally dozens of necessary approvals from creditors, co-owners, lessors, preferred
3 shareholders, vendors, regulators, etc. If those hurdles are overcome, there are the additional
4 transaction costs necessary to set up some manner of auction procedure or otherwise negotiate the
5 sale of thousands of MWs of generation. These two sets of transaction costs can easily run into
6 the tens if not hundreds of millions of dollars. It is not clear whether these costs would be
7 includible as stranded costs for even the 64% recovery allowed under Option No. 2.

8 C. Option No. 3 - Financial Integrity

9 This Option is so vague as to be practically meaningless. If it is meant to mirror Staff's
10 "transition revenue" approach, wherein "Affected Utilities" are given just enough recovery to avert
11 bankruptcy, it is clearly not "a reasonable opportunity to collect 100% of [their] unmitigated
12 stranded costs." *Id.* In addition, as will be discussed below, this Option would not avert
13 significant write-offs of stranded costs.

14 D. Other Restrictions on Stranded Cost Recovery

15 All three of the "Options" are subject to restrictions that may further reduce stranded cost
16 recovery below even the levels discussed above. For example, rates for "standard offer"
17 customers can not be increased even if the shortened period allowed for stranded cost recovery
18 does not permit full recovery without a rate increase. Such an involuntary rate "freeze" can just as
19 effectively and unlawfully deny recovery of stranded costs as any overt disallowance by the
20 Commission. Moreover, although the Recommended Order concedes that "Affected Utilities"
21 might incur legitimate stranded costs post-1996, it states "those costs, if reasonable, can be
22 factored into the market price." *Id.* at 14. If this simply means that the post-1996 stranded costs
23 are to be subtracted from the otherwise determined market price under the APS stranded cost
24 proposal (rather than added to the generation cost), the Company would agree that this would
25 effectively, if somewhat obtusely, allow for their recovery as stranded costs. If, on the other hand,
26 the Recommended Order meant to imply that these costs will necessarily be subsumed in the

1 market price of competitive generation, the statement is an oxymoron because stranded costs, by
2 definition, can not be recovered in a competitive market.

3
4 **III. THE RECOMMENDED ORDER WOULD REQUIRE SIGNIFICANT WRITE-OFFS
OF REGULATORY ASSETS PREVIOUSLY ASSURED OF FULL RECOVERY**

5 Regulatory assets reflect either prior costs incurred to provide service for which the utility
6 has not been reimbursed or prior benefits conferred upon ratepayers for which the utility has not
7 been compensated. They are perhaps the most clear cut example of the regulatory compact in
8 action. By their very definition, they represent promises by regulators of future cost recovery:

9
10 Regulatory assets arise only in the context of rate-regulated enterprises. In their simplest
11 terms, regulatory assets consist of costs that would have been charged to operating income
12 (as expense) in the period incurred absent an implicit promise by the entity's regulator that
they can be deferred on the balance sheet as an asset and charged to expense and collected
from ratepayers in future periods.

13 Of all the potential stranded costs that may be present in a utility's cost structure,
14 regulatory assets are the most likely not to be recovered in a competitive environment.
This occurs, in large part, because of the fact that their recovery is premised on a regulatory
promise.

15 Testimony of Staff Chief Accountant Randall W. Sable in Docket No. U-1345-5-491, APS Exh.
16 No. 6.

17 In the Company's case, there is nothing "implicit" about this Commission's promise. In
18 Decision No. 59601 (April 24, 1996), the Commission specifically and expressly authorized 100%
19 recovery of regulatory assets over an eight (8) year period ending July 1, 2004. Other of the
20 "Affected Utilities" are recovering their regulatory assets over longer periods of time.

21 As noted above, APS already has a Commission order that provides for the full recovery of
22 and return on its regulatory assets. Because that order can not be amended or rescinded in this
23 proceeding without specific notice to the Company and an opportunity for hearing "as upon
24 complaint" [A.R.S. § 40-252], the Recommended Order does not directly impact the Company
25 with regard to this issue. However, APS will address in its Exceptions below the Recommended
26 Order's generic treatment of the recovery of regulatory assets.

1 Under Option No. 1, a portion of regulatory assets would have to be written off to reflect
2 the phase-out of a return after year five (5). Depending on the current balance of unamortized
3 regulatory assets and the specific amortization schedule being used by a particular "Affected
4 Utility", the write-off could be in the hundreds of millions of dollars.⁵ Under Option 2, the write-
5 off of regulatory assets is more certain and could arguably be at least in the 36% range identified
6 above.⁶ Under Option 3, such write-offs of regulatory assets might be as high as 100%!

7 The Recommended Order acknowledges that regulatory assets are deserving of a higher
8 degree of protection than other forms of stranded costs. *Id.* at 10-11. This reflected what was
9 almost uniformly the position of the other parties - even those otherwise hostile to the concept of
10 stranded cost recovery. *Id.* at 17. There was also nearly universal acknowledgment that this
11 subset of stranded costs could not be mitigated by future actions of the "Affected Utility." The
12 Recommended Order further states that "significant write-offs of regulatory assets could seriously
13 impair the financial integrity of an Affected Utility." *Id.* at 11 (ft. nt. 4). The Recommended
14 Order finally goes on to indicate that its intent is to avoid such write-off or write-downs. *Id.* at
15 17.⁷

16 The only seeming explanation for the Recommended Order's approach to the recovery of
17 regulatory assets is found in the somewhat terse assertion that "there should not be an indefinite
18 guarantee of a return of and on the regulatory assets." *Id.* at 11. "Affected Utilities" have not and
19 are not seeking a "guarantee", indefinite or otherwise, of regulatory asset recovery - only what
20

21 ⁵ Such write-offs would likely occur even if the Commission were not to require that the reduced or
22 eliminated return on regulatory assets be immediately flowed through in the form of lower rates. *Recommended*
Order at 12. However, the existence of such a flow-through provision makes the write-off automatic.

23 ⁶ This assumes that regulatory assets could be "divested" at zero value. Most likely, they could not be
24 "divested" at all or only for negative value.

25 ⁷ "Affected Utilities" may not be able to await even a final Commission order in their individual stranded
26 cost proceeding before recording these write-offs. The mere entry by the Commission of the Recommended Order
without specific assurances of full recovery, including return, under each possible stranded cost option might in and
of itself trigger partial write-offs of regulatory assets.

1 they were promised by the Commission to begin with, which was no less than a reasonable
2 opportunity for full recovery of these costs, including return, over the period previously specified
3 by the Commission for such recovery.

4
5 **IV. THE RECOMMENDED ORDER'S ATTEMPT TO "ENCOURAGE" DIVESTITURE**
6 **OF GENERATING ASSETS THROUGH SEEMINGLY MORE FAVORABLE**
7 **TREATMENT OF STRANDED COSTS IS SIMPLY AN ATTEMPT TO COERCE THAT**
8 **WHICH THE COMMISSION CAN NOT LAWFULLY COMPEL**

9 The parties pushing divestiture most forcefully in this proceeding were either the
10 parties with a recognized self-interest in obtaining maximum competitive advantage or those least
11 familiar with regulated utilities and with regulation.⁸ However, this issue is far from being one of
12 first impression with the Commission. In Decision No. 59943, the Commission considered and
13 rejected the divestiture option:

14 [T]he Commission's regulatory authority to require divestiture of utility assets may
15 be questioned and result in a protracted legal dispute. Further, utilities, utility
16 shareholders, and utility debt holders may strongly resist divestiture. Divestiture
17 could be costly due to expensive debt re-financing. In addition, inefficiencies could
18 result from the loss of traditional coordination of generation, transmission, and
19 distribution services.

20 The restructuring policy proposed is preferred to [divestiture] because it:
21 minimizes administrative complexity; ... is relatively flexible so that policy could
22 be adjusted mid-course; ... minimizes utility organizational disruption; ... and
23 minimizes public confusion.

24 *Id.* at 63.

25 ⁸ For example, potential bidders PG&E and Enron support "voluntary" or "incentive" divestiture—i.e.,
26 divest or receive no stranded costs. Initial Brief of PG&E at 8; Initial Brief on Behalf of ECC and Enron at 7. Also,
Citizens—saddled with a 1996 purchased-power contract with APS that it now wants out of, and not possessing any
auctionable generation assets itself—proposes "voluntary" auction and divestiture, being sure to include purchased
power contracts in the assets to be auctioned. Then, to ensure that Citizens' contract would be among the assets
auctioned off under its proposal, Citizens adds a requirement that if APS wants *any* stranded cost recovery, it must
auction *all* of its resources. Citizens, however, has not proposed divestiture in the state in which it owns generation
assets. 1 Tr. 198 (S. Breen).

27 Certain other proponents of divestiture, such as the Department of Defense or the Arizona Consumers'
28 Council, are clearly unaware of the practical problems, time, and expense such a divestiture would entail. In contrast,
29 RUCO criticized divestiture, *see* RUCO's Initial Brief at 7-9, and Staff's economist testified to the impracticability of
the auction and divestiture approach, *see* 10 Tr. 3128-31 (K. Rose).

No party has pointed to any new circumstances since the Commission adopted Decision No. 59943 that would support changing the Commission's position on divestiture now. No party to this proceeding has provided a persuasive practical or economic basis to support divestiture. No party has presented any evidence that any of the "Affected Utilities" would exercise any vertical or horizontal market power by virtue of their continued ownership of generating resources. Indeed, Staff concluded as late as March 23, 1998 in its Reply Brief herein that divestiture should not be encouraged as a means of resolving the stranded cost issue. This was the same conclusion arrived at some six months earlier by 17 of the 18 voting members of the Commission's Stranded Cost Working Group. Reasons cited by the Stranded Cost Working Group for opposing divestiture were:

- 1) Costs for preparing the assets for sale and administering the auction were unknown but likely to be considerable and would add to stranded costs;
- 2) Sale of all generating assets within a short period of time may lead to "fire sale" prices, thus exacerbating the stranded cost problem;
- 3) Uncertainty as to the number of potential bidders;
- 4) The difficulty, time and expense of unwinding current contracts, soliciting shareholder and creditor approvals, etc.;
- 5) The difficulty if not impossibility under the Atomic Energy Act of divesting the ownership interest of the operating agent of a nuclear power plant;
- 6) The lack of Commission authority to require such a divestiture;
- 7) The existence of open-access transmission to sufficiently mitigate even the potential for acquiring market power, thus mooted a key perceived benefit of divestiture; and,
- 8) Because divestiture does not eliminate the need to forecast future market prices, it merely requires someone other than the Commission to do the forecasting, there is no *a priori* reason to believe that divestiture will produce a more accurate estimate of stranded costs than other less drastic methods.

See Stranded Cost Working Group Report at 24-25, 27-28 (Sep. 30, 1997).

A. Compelled Divestiture is Unlawful

Although several parties to this proceeding purport to identify "conceptual" benefits of

1 divestiture, they fundamentally fail to recognize that the Commission cannot lawfully compel (or
2 coerce) divestiture of generation assets.

3 1. *The Commission Lacks the Authority to Order Divestiture*

4 In addition to the Commission orders recognizing the lack of authority which were cited in
5 APS' Initial Brief in this proceeding,⁹ courts have rejected the argument that a commission can use
6 its power of regulatory oversight to compel divestiture of a utility's assets. *Public Utils. Comm'n*
7 *v. Home Light & Power Co.*, 428 P.2d 928, 935 (Colo. 1967). In *Home Light & Power*,
8 certificated and non-certificated electric utilities—all subject to commission jurisdiction—were
9 encroaching on each other. The Colorado PUC's solution was to order some of the utilities to sell
10 lines and facilities to the other companies. *Id.* at 931. The Colorado Supreme Court rejected this
11 abuse of power out of hand: "To order the sale of facilities would constitute a taking of the
12 property without just compensation . . ." *Id.* at 935. The court concluded that if the commission
13 found a sale price to be unreasonable, it could refuse approval, but the commission could not order
14 a sale or fix the sale price itself. *Id.*

15 2. *The Commission Cannot Exercise the Power of Eminent Domain to Compel*
16 *or Coerce Divestiture*

17 The unconstitutional taking referred to in the *Home Light & Power* opinion—and the
18 compelled divestiture at issue here—unquestionably involves the attempted exercise of the power
19 of eminent domain. *See, e.g., Hawaiian Housing Auth. v. Midkiff*, 467 U.S. 229, 241-42 (1984).
20 In *Midkiff*, the Hawaii legislature, invoking its power of eminent domain, enacted a statute that
21 allowed the state to acquire property from landowners of large estates and resell the property to
22 private citizens in smaller, residential lots.¹⁰ *Id.* If the Commission were to order or coerce an

23 ⁹ *Re Elec. Ind. Restructuring* 163 P.U.R.4th 96, at n.31 (Mass. D.P.U. 1995); *Carmel Mtn. Ranch v. San*
24 *Diego Gas & Elec. Co.*, 1988 Cal. P.U.C. LEXIS 67 at *14-15 (Mar. 9, 1988). *See also Re Arizona Corp. Comm'n*,
25 P.U.R. 1919E, at 566 (holding that Arizona Corporation Commission lacked the authority to compel a water company
to acquire the assets of another water company).

26 ¹⁰ In *Midkiff*, the petitioner argued that a resale to private parties did not satisfy the "public use"
requirement under the Fifth Amendment. Although the Court in *Midkiff* concluded that "public use" was satisfied

1 affected utility to sell its property *directly* to a private purchaser, this would involve the same
2 exercise of “eminent domain” power analyzed in *Midkiff*. *See id.* The Commission cannot effect a
3 physical taking of a utility’s property by removing the “middleman” and calling the physical
4 confiscation “regulation.”

5 Moreover, unlike the Hawaiian Legislature in *Midkiff*, however, the Commission lacks the
6 fundamental power of eminent domain needed to order such a property sale. *See City of Phoenix*
7 *v. Donofrio*, 99 Ariz. 130, 133-35, 407 P.2d 91, 92-94 (1965); *GTE Northwest v. Public Util.*
8 *Comm’n*, 900 P.2d 495, 498-501 (Ore. 1995). In *Donofrio*, the Arizona Supreme Court held that
9 the legislature alone possessed the inherent power of eminent domain, and that political
10 subdivisions of the state could only exercise eminent domain authority for specific, legislatively-
11 delegated purposes. 99 Ariz. at 134, 407 P.2d at 93-94. In *GTE Northwest*, the Oregon Supreme
12 Court invalidated the state utility commission’s attempt to exercise eminent domain authority
13 because the legislature had not expressly delegated such authority to the commission. 900 P.2d at
14 498-501.

15 Similarly, in this case, the Commission possesses no implied power. *Commercial Life Ins.*
16 *Co. v. Wright*, 64 Ariz. 129, 139, 166 P.2d 943, 949 (1948). The Commission lacks the express
17 legislative authority to compel the physical divestiture of a utility’s property. For example, the
18 Commission has no authority to compel divestiture under the general eminent domain statute. *See*
19 A.R.S. § 12-1111; *City of Mesa v. Smith Co.*, 169 Ariz. 42, 816 P.2d 939 (Ct. App. 1991) -
20 (permitting condemnation of “buildings and grounds” only for use as administrative facilities for
21 city). No authority to force divestiture can reasonably be inferred from the Commission’s
22 legislatively-delegated power to order improvements or modifications to existing utility plant. *See*
23 A.R.S. § 40-331. Nor can authority be found in the Commission’s power to order *joint* use of

24 _____
25 because the legislature desired to mitigate the oligopoly created by large estate holders, no “public use” results from
26 compelled divestiture of generation assets to private parties merely to effect a market valuation of private property.
This issue need not be reached, however, as the Commission lacks the eminent domain authority which is a necessary
precursor to this analysis.

1 facilities. See A.R.S. § 40-332. When the condemning entity is without authority to exercise
2 eminent domain, the question of compensation for the taking is irrelevant. *GTE Northwest*, 900
3 P.2d at 498.

4 3. *Divestiture is an Equitable Remedy Vested in the Judicial Branch, Not the*
5 *Commission*

6 Divestiture is a judicial *remedy*; it is not a tool for regulation (or deregulation) by the
7 Commission. The United States Supreme Court has repeatedly stated that the purpose of
8 divestiture is “remedial and not punitive.”¹¹ See, e.g., *United States v. E. I. Du Pont de Nemours &*
9 *Co.*, 366 U.S. 316, 349 (1961) (citing cases). Courts also recognize that divestiture, even in the
10 context of an antitrust case, is a “drastic” remedy that is not appropriate when other, less drastic
11 alternatives will remedy a *violation* of law. See, e.g., *id.* (emphasis added). Apart from the fact
12 that there is no “violation” to be “remedied” in this proceeding, the Commission is not vested with
13 the broad equitable powers of the judicial branch such that the Commission could issue a
14 divestiture order. See *Commercial Life Ins. Co.*, 64 Ariz. at 139, 166 P.2d at 949 - (holding that
15 the Commission has no implied powers); see also A.R.S. § 40-422 - (requiring the Commission to
16 apply to the Superior Court for equitable remedy).

17 Moreover, other less drastic methods¹² of valuing generation assets have been presented to
18 the Commission. Indeed, the availability of less drastic methods is all the more significant because
19 (1) divestiture will not obtain a valuation of all generation assets (i.e., nuclear facilities, regulatory
20

21 ¹¹ For example, the so-called *Schine Theaters* three-part rationale for divestiture speaks clearly and loudly
22 in remedial terms: (1) divestiture puts an end to a statutory “violation”; (2) it deprives “violators” of the benefits of
23 their “conspiracy”; and (3) it “renders impotent” monopoly power “violations” of the antitrust laws. *Schine Chain*
24 *Theaters v. United States*, 334 U.S. 110, 128-29 (1948), *overruled on other grounds by Copperweld Corp. v.*
25 *Independence Tube Corp.*, 467 U.S. 752 (1984). Clearly, these rationales are wholly inapplicable in the valuation
26 context presented in this proceeding.

¹² Compelled divestiture of a public service corporation’s generation assets merely to value stranded costs
also violates constitutional guarantees of due process and equal protection. See U.S. Const. amends. V & XIV; Ariz.
Const. art. 2, § 4 & art. 2, § 13; *Bryant v. Continental Conveyor & Equip. Co.*, 156 Ariz. 193, 197, 751 P.2d 509, 513
(1988), *overruled on other grounds, Hazine v. Montgomery Elevator Co.*, 176 Ariz. 340, 861 P.2d 625 (1993); *Big D*
Const. Corp. v. Court of Appeals, 163 Ariz. 560, 566-69, 789 P.2d 1061, 1067-70 (1990).

1 assets, above-market power contracts, must-run units, etc.), *see, e.g.*, 4 Tr. 1258 (D. Ogelesby),
2 and (2) several parties assert that an administrative valuation is necessary in any event to enable
3 the Commission to approve, or allow it to reject, any market-based sale, *see* RUCO's Initial Brief
4 at 7-8.

5 B. Coerced Divestiture is Equally Unlawful

6 The Commission cannot condition recovery of stranded costs (to which APS is entitled) on
7 the divestiture of APS' generation assets. *See Dolan v. City of Tigard*, 512 U.S. 374, 385 (1994) -
8 (holding that doctrine of unconstitutional conditions precludes government from requiring person
9 to surrender the right to receive compensation for a state taking to obtain a discretionary benefit
10 from the state); *Davis v. Hale*, 96 Ariz. 219, 225, 393 P.2d 912, 916 (1964) - (holding that a city
11 cannot "do indirectly what it could not do directly"). Several parties to this proceeding
12 erroneously suggest that, if the Commission has concerns over its authority to compel divestiture,
13 all it need do to finesse around this lack of authority is coerce the Affected Utilities to divest by
14 making stranded cost recovery contingent on divestiture.¹³ Initial Brief of PG&E at 9; Citizens'
15 Initial Brief at 15. Such a disingenuous proposal will not withstand judicial scrutiny, and the
16 Commission cannot conclude that it has authority to indirectly compel divestiture.

17 C. From a Policy Standpoint, Compelled or Coerced Divestiture is Both Unwise and
18 Uneconomic

19 Requiring divestiture to value stranded costs is "a case of the tail wagging the dog." Ex.
20 APS-3 (W. Heironymus Rebuttal Testimony). The stranded cost valuation methodology adopted
21 in this proceeding must not dictate the market structure for Arizona utilities. *Id.* Moreover,

22 ¹³ PG&E, for example, claims that their "voluntary" divestiture proposal was discretionary, and claims that
23 Mr. Fessler acknowledged this. Initial Brief of PG&E at 9. All that Mr. Fessler acknowledged, however, was that
24 choosing between divestiture or no stranded cost recovery "would have an *element* of discretion in it." 2 Tr. 586
25 (emphasis added). Moreover, California did not coerce divestiture, as Mr. Fessler took pains to demonstrate, when it
26 negotiated the partial sale of the non-nuclear assets of some California utilities. Mr. Fessler stated that the
Commission "emphatically did not require [divestiture]." 2 Tr. 523. Indeed, California has selected administrative
valuation for those assets which are not divested. Preferred Policy Decision at 54-55. Further, tying divestiture to
securitization, rather than denying stranded cost recovery, is not the equivalent of coercing divestiture; the utility is
still entitled to recover its stranded costs. *See, e.g.*, Mass. Gen Laws ch. 164, § 17(B) (1996).

1 although a number of parties in this proceeding point to alleged "conceptual" benefits of
2 divestiture, these parties ignore the practical barriers that militate against compelled divestiture.

3 First, for example, a compelled auction and divestiture process will not be developed and
4 concluded overnight.¹⁴ There will be legal challenges that must be resolved prior to moving
5 forward with any sale. Divestiture plans or a divestiture rulemaking proceeding must be proposed
6 and resolved by the Commission during the busiest period in the restructuring process. Auctions
7 must be conducted over time to avoid distorting valuations by the temporary oversupply created if
8 all plants and assets are sold at once. *See* Ex. APS-4 (J. Landon Rebuttal Testimony) at 27.

9 Second, the market for generation assets is undeveloped; there is certainly a risk that, rather
10 than premium prices touted by divestiture proponents, compelled auctions will net "fire sale" or
11 substantially below-book prices, resulting in increased stranded costs (with no mitigation
12 alternatives) for Arizona consumers and a "windfall" for a handful of large out-of-state
13 corporations. *See, e.g.*, 1 Tr. 235 (S. Breen). Pinning all the Commission's hopes on the results of
14 a few out-of-state generation plant sales, made under circumstances not present in Arizona, is not
15 prudent policy-making. For example, TEP testified how prior above-book sales of out-of-state
16 plants may be illusory when compared to Arizona facilities:

17 The thing I do not know, which is critical to all of this, is the fuel contracts
18 at those plants. A one-cent decrease in our fuel price at a plant is going to affect the
19 net present value of that plant by close to a billion dollars. So a plant with a one-
cent contract is a far different animal than a plant with a two-cent contract....

20 The other thing that will affect the plant sales price is the perceived
21 electricity price in [the] region. You can't get as much gas in New England as you
22 can here. The pipeline capacity just isn't there.... If we were going to get four
times book, believe me, the "for sale" sign would be hung from the top of the plant.
But I don't believe that would be the case.

23 5 Tr. 1529 (C. Bayless).

24 Third, and as discussed previously, high transaction costs may significantly affect the

25 ¹⁴ TEP President Charles Bayless testified that a divestiture approach would take at least one year, and
26 probably longer. 5 Tr. 1531 (C. Bayless). TEP has subsequently indicated to Staff that 18 month to two years was
more realistic. APS believes that even two years would be optimistic, at least in its situation.

1 outcome of any sale. Complex power contracts, labor contracts, mortgage covenants, and debt
2 obligations tied to the asset must be transferred, unwound or otherwise resolved. For jointly-
3 owned facilities or investor-owned utilities, consents must be negotiated with shareholders,
4 partners and creditors. *See, e.g.* 6 Tr. 2055 (W. Edwards). Further, if divestiture is compelled,
5 either directly or indirectly, the bargaining power of the "Affected Utility" seeking to resolve these
6 issues is completely undercut, a difficulty further compounded by the complicated sale/leaseback
7 financing for several APS generating units. *See* 7 Tr. 3743 (J. Davis). The result: the net
8 proceeds from the resulting sale are lower and stranded costs necessarily higher than if such
9 divestiture were voluntarily pursued by the Company over a more reasonable period of time for
10 legitimate business reasons.

11 Fourth, and of particular significance in Arizona, the vast majority of parties agree that
12 nuclear assets cannot be reasonably divested. *See, e.g.* 1 Tr. 99 (S. Breen); 3 Tr. 838-39 (M.
13 Petrochko) - (noting that no bids could be solicited for Maine nuclear plants); 4 Tr. 1258 (D.
14 Ogelesby). Any sale of even an interest in a nuclear facility will be subject to extensive Nuclear
15 Regulatory Commission ("NRC") oversight and control. Moreover, APS holds the operator's
16 license for Palo Verde, which would be even more difficult to divest than an ownership interest.
17 To the Company's knowledge, the NRC has never approved the transfer of an ownership interest
18 in an operating nuclear power plant to a non-affiliated party. Even if such a transfer were possible,
19 it would require that the transferee have experience operating a nuclear power plant - a factor that
20 guarantees that Palo Verde's safe and efficient operation would become the responsibility of some
21 as of yet unknown foreign corporation.

22 Fifth, there are compelling economic reasons to reject divestiture. Horizontal market
23 power in a given region may increase depending on what entity purchases the asset. *See* 1 Tr. 196
24 (S. Breen). Economies resulting from integrating generation and distribution are precluded.
25 Indeed, the Economic Impact Statement adopted by the Commission recognized this economic
26 inefficiency when rejecting divestiture. Decision No. 56693 at 63.

1
2 **V. THE AUTOMATIC RATE DECREASES CALLED FOR UNDER THE
RECOMMENDED ORDER ARE UNCONSTITUTIONAL**

3 As noted earlier in these Exceptions, the Recommended Order would automatically reduce
4 rates to reflect the loss of return on regulatory assets. Such single issue rate making has long been
5 decried by the Commission and has been found unconstitutional by Arizona courts:

6 As special counsel for the Commission's staff pointed out during the course of this
7 hearing, such a piecemeal approach is fraught with potential abuse. Such a practice
8 must invariably serve both as an incentive for utilities to seek rate increases each
time costs in a particular area rise, and as a disincentive for achieving
countervailing economies in the same or other areas of their operations.

9 *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 534, 578 P.2d, 612, 615 (App. 1978).

10 In its *Scates* opinion, the Court of Appeals relied heavily on the Arizona Supreme Court's earlier
11 holding in *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956). In
12 *Simms*, a Commission-ordered involuntary rate reduction imposed without a full rate proceeding
13 determining fair value and a reasonable rate of return thereon was found to violate the utility's
14 constitutional rights. Although there are admittedly some exceptions to *Scates*, they are clearly
15 inapplicable in the situation posited by the Recommended Order, and the Recommended Order
16 does not even allude to let alone claim the existence of any such exception.

17
18 **V. MISCELLANEOUS EXCEPTIONS**

19 At various points in the Recommended Order, substantive language in the existing
20 competitive rules is either expressly or implicitly modified. For example, pages 13 through 17
21 discuss proposed changes to A.A.C. R14-2-1607. On the other hand, both the establishment of the
22 three (3) "Options" and the later discussion of a "price cap" or "rate freeze" (p. 18) implicitly
23 amend that same regulation. It is unclear whether any or all of these change, both implicit and
24 explicit, are to be considered more or less "self-executing" by virtue of the Commission's
25 presumed adoption of the Recommended Order, or must there be subsequent rule making before
26 the changes become effective? APS urges the Commission to be very specific in its final order


1 concerning those portions of its decision that are deemed immediately effective as contrasted with
2 those positions that will necessarily be reflected in subsequent proposed amendments to the
3 existing stranded cost regulation.

4 VI. CONCLUSION

5 The Recommended Order is deficient in numerous respects. Despite its rhetoric about
6 providing "Affected Utilities" a reasonable opportunity for full stranded cost recovery, as called
7 for in A.A.C. R14-2-1607 and as required by our state and federal constitutions, the
8 Recommended Order falls far short of its stated goals. However, with the amendments suggested
9 herein, it could be transformed into the basis for a final resolution of this contentious issue that is
10 consistent with the Commission's prior regulatory promises, not the least of which was that made
11 in the original stranded cost regulation, concerning recovery of prudently incurred costs.

12
13 RESPECTFULLY SUBMITTED this 29th day of May, 1998.

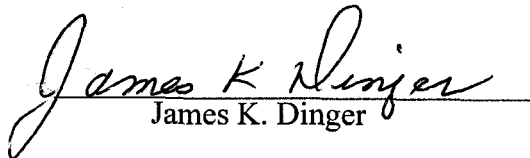
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17 Steven M. Wheeler
Thomas L. Mumaw

18 Attorneys for Arizona Public Service Company
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CERTIFICATE OF SERVICE

The original and ten (10) copies of the foregoing document were filed with the Arizona Corporation Commission on this 29th day of May, 1998, and service was completed by mailing or hand-delivering a copy of the foregoing document this 29th day of May, 1998, to all parties of record herein.


James K. Dinger